

Markets

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Markets are institutions that enable exchange of goods and services to take place between buyers and sellers. They play a central role in allocating resources and distributing income in most modern economies. More generally, the market mechanism can be thought of as a process by which the decisions taken by different agents in the economy – individuals' decisions about consumption of alternative goods, firms' decisions about what and how much to produce, workers' decisions about work, and so on – are all co-ordinated through adjustments in prices.

Markets and efficiency

The market mechanism has several important advantages. It co-ordinates decentralised decisions by a very large number of economic agents without the need for conscious control. It provides strong incentives and disciplines producers against wasteful use of resources. It conveys information about constantly changing market conditions and allows for flexibility in decision-making. Finally, it does not usually lead to excessive concentration of economic power.

In a “perfectly competitive” market, sellers sell a homogeneous product; both buyers and sellers are price-takers, i.e., each agent perceives herself as so small relative to the market as a whole that her decisions have no effect on the market price or the behaviour of the other agents; buyers have perfect information on prices; and there are no restrictions on entry and exit in the long run. Economists have established two important welfare properties of perfectly competitive markets.

First, in the absence of externalities (see below) and under certain conditions that ensure that an equilibrium exists, perfectly competitive markets achieve an efficient allocation of resources, in the sense that it is impossible to make any individual better off without simultaneously making someone else worse off. Second, again under certain conditions that have to do with the kind of preferences consumers have and the kind of technological constraints firms face, any desired efficient allocation of resources can be achieved for some initial distribution of lump-sum income. Thus to change the distribution of resources in society, one need only redistribute lump-sum income and let the price mechanism operate freely to achieve efficiency.

Market failure

The large majority of product and labour markets are not perfectly competitive, however. In fact, many product markets, especially for manufactured products, are oligopolistic, i.e., the number of firms is relatively small and/or there are a few firms with large market shares. In these circumstances, each firm has some market power, in the sense that it can affect the market price and this price is higher than marginal cost. Furthermore, each firm recognises that its decisions will affect the decisions of other firms in the market, which leads to strategic interaction between firms. Firms in oligopolistic markets often produce differentiated products and compete not only on price, but also on several other dimensions, such as product quality and characteristics, advertising, location, pre-sale and after-sale services, and so on.

Unlike perfectly competitive firms, oligopolistic firms may enjoy positive net profits – these are sometimes substantial, but more often they are restricted by free entry. Since price in oligopoly is set above marginal cost, production is lower than the socially optimal level and resources are not allocated efficiently.

Imperfect competition is an important source of inefficiency in a market economy. Imperfect competition in product markets cannot be avoided, however, because there are many industries in which the minimum scale for efficient operation of firms is simply too large relative to the size of the market to support many competing firms. Moreover, a firm may possess market power because it is efficient or innovative, and some degree of market power may be desirable in order to provide incentives to invest and innovate. The aim of government policy is not therefore to achieve a state of perfect competition, but to ensure that competition between firms is “effective”, i.e., firms do not collude or otherwise abuse their market power and there are no barriers to entry. In situations where effective competition is difficult or impossible because firms possess a lot of market power and are likely to abuse it, the direct regulation of firms becomes necessary. This is typically the case in industries whose technological characteristics are such that average industry cost is minimised when a single firm or very few firms serve the whole market.

A second source of inefficiency in a market economy is the existence of “public goods”, i.e., goods that are non-rival (so that the fact that one person is enjoying the good does not prevent another person from enjoying it) and non-excludable (so that a person cannot be made to pay for the good by being excluded from enjoying it if she does not pay). Examples of public goods are national defence, and law and order. In the absence of government intervention, the market provides a lower than optimal amount of public goods because of the free rider problem, i.e., the incentive for individuals to understate their willingness to pay for these goods.

A third source of market failure is the existence of externalities. An externality arises whenever consumption or production by one person or firm directly affects consumption or production by another person or firm. For example, pollution is a negative externality, while education may give rise to positive externalities. A firm that produces a product through a pollution-intensive technology does not take into account the effect of pollution on the welfare of others when deciding how much to produce, what technology to use, and so on. In the absence of government intervention, the market will provide a larger than optimal amount of goods and services with negative externalities and a lower than optimal amount of goods and services with positive externalities. There are a number of ways that the government can deal with externalities. These include taxing or subsidising certain activities; imposing standards or quantity restrictions; or creating a market for the externality (for instance, in the case of pollution, by introducing tradable pollution permits).

A fourth important source of market failure is missing markets (such as for certain types of insurance) and incomplete or asymmetric information. Incomplete information may lead to private choices by individuals that do not represent their best interests. This is part of the reason why governments set health, safety and quality standards, and it also helps to justify government intervention in health care and education.

Government intervention in a market economy can be justified for all the reasons described above, but also for distributional reasons. Markets cannot be relied upon to produce the distribution of income, wealth, skills, health care, and so on, which a society finds desirable. Because redistribution of lump-sum income is difficult in practice, redistribution occurs primarily through taxes and subsidies that also affect the incentives and economic decisions of individuals and firms. This implies that there is often a trade-off between economic efficiency and income redistribution, although there is probably no simple relationship at the macroeconomic level between the degree of inequality and long-run economic growth.

Markets versus governments

Although government intervention can often improve on market outcomes, it does not always do so. First, governments are often not sufficiently well informed, or they are not as well informed as private agents, about various parameters that affect optimal economic decisions. Second, politicians and civil servants have their own objectives, monetary or non-monetary (such as job security or getting re-elected), and they are not necessarily aiming to minimise economic inefficiencies or achieve a more desirable distribution of income when designing and implementing economic policies. Third, government intervention often implies significant administrative costs and inefficiencies caused by weak or distorted incentives and lack of proper monitoring. Fourth, government involvement creates opportunities for rent-seeking activities and lobbying by various special interest groups; this implies a waste of resources and is also likely to distort policy outcomes. In debates about the proper role of government, therefore, the relevant comparison is often between an imperfect market outcome and an imperfect government intervention.

Government intervention in the market can take many forms: taxes and subsidies, imposition of standards, competition policy, regulation, franchising (i.e., selling the right to serve a market for a certain period to a private firm), and government provision of goods and services. The case for government provision is considerably weaker than the case for other kinds of government intervention in the market. Nevertheless, it may be justified under certain circumstances or for certain kinds of goods and services. In particular, government provision may be superior to provision by private firms when there are significant opportunities for cost reduction in the production process that lead either to the deterioration of quality beyond what is socially desirable or to unequal access to the good or service, *and* quality or universal access cannot be easily observed and specified in a contract between the government and a private firm. Otherwise private ownership or government ownership with contracts to the private sector for the provision of the good or service (with or without regulation) might be better alternatives.

Further reading

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